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NF91-2 Acquiring Credit

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Acquiring Credit

Adapted by Kathy Prochaska-Cue, Family Economics and Management Specialist

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Acquiring credit means you can use someone else's money for a certain period of time to expand your immediate purchasing power. Being aware of the types of consumer credit and the ways in which you are protected by law will help you get the most out of your money.

Kinds of Credit

Consumer credit includes all forms of credit except household mortgages. Two kinds of consumer credit are sales credit, granted with the purchase of merchandise or services, and cash credit, the loan of money.

Each kind of sales credit has unique features and can be obtained from businesses such as department stores, specialty stores, furniture or appliance dealers, pharmacies, florists, automobile dealers, contractors and repair persons. Sales credit includes 30-day accounts, revolving charge accounts, and installment plans.

The 30-day account does not incur a finance charge when paid within the time limit. You will be billed monthly for all the money you owe for items charged on a 30-day account. A revolving charge account, however, requires your signature on one credit contract (agreement). This contract covers all the goods and services you will buy on your account. Most lenders set a limit to the amount that you can charge. You must pay the full monthly bill or a portion of the balance. A finance charge is due if the balance is not paid in full. Installment credit requires a signed separate contract each time you make a purchase. The amount you owe is divided into a given number of monthly payments called installments. The installments include the cost of credit. Usually a downpayment is required. If you can afford a large downpayment your monthly bills will be smaller.

Cash credit is used most often either to obtain goods and services that are expensive or to meet emergencies. This type of credit may be obtained from commercial banks, savings and loan associations, credit unions, consumer finance or loan companies, or the company that issued your life insurance policy. (Note: a life insurance company may lend up to 95 percent of the policy's cash value at a low interest rate.) Three basic kinds of cash credit are available: single payment loans, installment loans and checking account credit plans.

Single payment loans are arranged for large or small amounts of money. You, the borrower, agree to repay the entire amount on a specified date. You probably will need to give the lender collateral (something of value put up by the borrower to guarantee repayment of the loan). Installment loans usually require collateral, and can be repaid weekly or monthly. If the loan is not paid the lender gets the collateral. Forms of collateral include a car or boat, savings accounts and stocks or bonds. Your home is used as security (collateral) for a home equity loan. Checking account credit plans, commonly called ready reserve checking accounts, allow you to overdraw your checking account up to a certain limit. Actually, you are taking out a loan from the bank in which you have your checking account.

Bank cards such as Visa, MasterCard and other cards for which you pay a membership fee, such as American Express, can be used for sales or cash credit.

Qualifying for Credit

You must show potential creditors that you are credit worthy to qualify for credit. While lenders use various criteria to judge credit qualifications, ability to repay debt and willingness to do so are the primary considerations. Characteristics usually examined include income, which measures ability to repay debt, and credit history, which indicates willingness to repay.

Your credit history is a record of contracted debt such as charge accounts, installment loans and mortgage payments. Lenders believe that the way debt has been handled in the past is an indication of how credit obligations will be met in the future. While many consumers prefer to operate using cash transactions, they should realize they will lack a credit history.

Establishing a credit history takes time. Unfortunately when credit is needed, it usually is needed right away. To be prepared for a situation such as a financial emergency when you need credit, take steps to build a credit history now. You need to establish your credit identity regardless of sex or marital status.

Lenders will look at other factors when determining whether you qualify for credit. Owning versus renting your home, the number of years you have been at your residence, and how long you have been employed at your job are viewed as measures of your stability. Outstanding debt also is considered.

A lending institution can no longer deny credit on the basis of your sex, race, national origin or marital status. If you feel that a creditor has denied you credit because of erroneous and outdated facts on your credit history you have the right to be told the name and address of the credit bureau that supplied information about you. You can go to the credit bureau and ask about the information, then have the incorrect material removed.

Advantages and Disadvantages of Credit

Only you know how you want to spend your money. Your decision to use credit should be based not only on your needs and wants but also on your financial ability to meet payments. It is a good idea to analyze your financial situation in terms of the money you earn and the expenses you must meet.

As a skillful consumer, consider the advantages and disadvantages of using credit in your particular, financial situation.

Advantages

- Credit is handy and convenient.

- You can meet temporary emergencies and difficulties.
- You do not have to carry large sums of money.
- You can use an item while you are paying for it.
- You may get better service on credit merchandise.
- You can take advantage of sales.
- You can establish a credit history.
- Credit is a type of forced savings.

Disadvantages

- Credit almost always costs money.
- You may overspend.
- You may be discouraged from comparison shopping.
- Credit contracts are difficult to understand.
- Overuse leads to a poor credit rating.
- Your future income is tied up

Costs of Credit

The Federal Truth-in-Lending law requires lenders to tell you the annual percentage rate (APR) and the total finance charge in dollars. However, they may not do so. A few lenders are ignorant of the law while others may attempt to hide the true interest rate. In some cases, the exact annual percentage rate will not be known until all the specifics of the transaction have been decided. You must be sure that you are being quoted the annual percentage rate and that it is the rate written into the credit contract. You can then compare rates for the best deal.

When the lender quotes you a simple interest rate of 6 percent on a $500 loan borrowed for 1 year, the interest is calculated using the simple interest rate formula:

I = PRT,
where I = interest
P = principal (amount borrowed)
R = rate of interest
T = time of loan in years.

Using the figures given, the interest is calculated to be $30:

I = $500 X 0.06 X 1 = $30.

It is important to determine whether the true (effective) cost of borrowing the $500 is the stated 6 percent interest.

In most instances you will not be allowed the use of the full $500 for the entire year. Therefore, assume the loan will be paid off in 12 equal monthly installment payments beginning in 30 days. You have full use of the entire $500 for only the first month. Since the loan is completely paid off at the end of the year you will owe an average balance for the year of approximately $250. A $30 interest charge on an average outstanding balance of $250 is, in reality, costing 12 percent a year. In this case, the effective cost of borrowing (APR) is twice as large as the stated interest rate.

You can use the following formula to determine the effective cost of borrowing. It will give you the

approximate annual percentage rate of interest (APR).

$$APR = \frac{2 \text{ x } f \text{ x } n}{a \text{ x } (t+1)}$$

Where f = finance charge
n = number of payments per year
a = amount to be repaid
t = total number of payments

The finance charge is the amount of money you pay for the use of credit. When lenders state the finance charge, they must include the interest charge and other fees that are part of the credit transaction. For example, they would have to include the loan origination fee, processing fees, premiums on credit life insurance, and any other fee that is a required part of the credit offer.

To illustrate the use of the annual percentage rate formula, assume that you purchase a washing machine for $440, make a downpayment of $40, and borrow the remaining $400 at a stated interest rate of 10 percent. The loan is to be paid off in 18 equal monthly installments.

The finance charge can be calculated using the simple interest rate formula (I = PRT):

I + $400 x 0.10 x 1.5 = $60.

You are borrowing $400 (P) at 10 percent (R) for 1+ years (T) and you will owe a $60 finance charge (I). The number of yearly payments is 12, and the total number of payments is 18. The amount to be repaid includes your $400 loan plus the $60 finance charge or $460.

$$APR = \frac{2 \text{ x } 60 \text{ x } 12}{460 \text{ x } (18 + 1)} = \frac{1{,}440}{8{,}740} = 16.5 \text{ percent}$$

Let us further assume that the lender requires a loan application fee of $10 and a processing fee (credit check) of $25 in the aforementioned problem. The annual percentage rate will reflect the increase in your finance charge from $60 to $95.

$60 interest
10 loan application fee
+25 processing fee
$95 total finance charge

$$APR = \frac{2 \text{ x } 95 \text{ x } 12}{495 \text{ x } (18 + 1)} = \frac{2{,}280}{9{,}405} = 24 \text{ percent}$$

In this example the lender gave you a stated interest rate of 10 percent; yet you actually are paying an annual percentage rate of 24 percent. This accounts for the fact that you do not have the use of the full $400 for the entire loan period of 18 months.

Some lenders want their interest in advance. They make discounted loans. The finance charge is deducted from the amount you borrow when you take out the loan. In the aforementioned example you borrowed $400. The lender will subtract the $95 finance charge and you will receive $305. you will pay back the amount you borrowed ($400) in 18 equal monthly installments. The annual percentage rate will be much higher because you have the use of less money.

$$\text{APR} = \frac{2 \times 95 \times 12}{400 \times (18 + 1)} = \frac{2,280}{7,600} = 30 \text{ percent}$$

At this rate, you will not have enough money to buy the washing machine with the discounted loan for $400.

This method of determining the true cost of borrowing should be used to verify the APR when your payment schedule calls for regularly occurring payments of equal amounts. But, remember a lender is required to tell you the APR and the finance charge.

To get credit at the least cost, it is wise to shop in two or three places for the lowest APR and finance charge. You should compare the cost of credit in terms of time. The longer it takes you to repay a loan the higher your finance charge will be. But short-term loans require larger payments than long-term loans. Usually credit unions charge the lowest APR. Finance companies generally are the most expensive places to go for a loan.

Credit card companies charge a monthly interest rate for the use of credit. They also may charge an annual fee. Monthly interest rates for credit cards are quoted at 1 percent or more per month. This sounds inexpensive. But this interest is only for 1 month. The true annual percentage rate is the monthly quote multiplied by 12. Interest at 1+ percent a month would be 18 percent a year.

Most people do not know what method a credit card company uses to determine the finance charges on their bills. There are three methods of determining the finance charge: previous balance, average daily balance and adjusted balance. The previous balance method is the most expensive because the charge is calculated on the previous balance unless you pay the bill in full. Credit card companies use the second method when they base the finance charge on the calculated average daily balance. This method is the most equitable and issued widely. The third method, adjusted balance, is the least expensive because the finance charge is calculated on the balance after you make your payment. Of course, if you pay the bill in full each month you will not pay a finance charge.

Shop for your credit cards just as you do your loans. Compare monthly interest rates, annual fees and methods of determining the finance charge. You can reduce the cost of credit if you:

- Make as large a down payment as possible.
- Borrow the least amount possible.
- Shop for the lowest annual percentage rate.
- Pay back the loan quickly by arranging the highest monthly payment you can afford.
- Pay your bills on time.
- Only use credit when you really need it.

Reviewing the Contract

If you decide to use credit, you will be asked to sign a contract. The contract is legally binding in court.

The following information should be clearly stated on the contract:

- The cash price.
- The downpayment or trade-in value and remaining balance.
- The finance charge in dollars and cents.
- The annual percentage rate.
- All other charges not included in the cash price.
- The number, dollar amount and due dates of payments.
- The charge for a late payment.
- A description of collateral held by the creditor.

If you do not understand the entire contract, be sure you ask someone from the credit department to explain it to you. You are obligated to fulfill your credit responsibilities once you sign the contract.

When you borrow, you promise to do the following:

- Pay back the amount of money you borrow, plus the finance charge.
- Pay back your debt regardless of any personal crisis or unexpected situation.
- Make your payments on time.
- Keep any item that has been used as collateral until all payments have been made.
- Give back what you are buying if you cannot finish paying for it.
- Take responsibility for the loss of value to the item you bought on credit if it has to be returned to the creditor.

Summary

Acquiring credit creates financial obligations. It is quite easy to become overextended and jeopardize the financial future of your family. You should know how much debt you can afford and become aware of the danger signs of credit abuse.

Adapted by Kathy Prochaska-Cue, Family Economics and Management Specialist, University of Nebraska from publication written by Mary J. Stephenson, University of Maryland.

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